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What are illicit financial flows?
Concepts for their measurement in official statistics

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Abstract:
Illicit financial flows (IFFs) stem from various activities, including organized crime, trade in illegal goods, corruption and illegal and illicit tax and commercial practices. The related financial flows move across borders draining resources from development and hampering progress towards the 2030 Agenda. IFFs also affect the quality of key economic statistics, such as GDP, if they remain unidentified. The United Nations Conference on Trade and Development (UNCTAD) and the United Nations Office on Drugs and Crime (UNODC), as custodians of Sustainable Development Goals (SDG) indicator 16.4.1, lead methodological work to develop statistical definitions and methods to measure the total value of inward and outward IFFs. The concepts and methodology were approved globally by the Inter-Agency and Expert Group on SDG indicators (IAEG-SDGs) and thereafter by the UN Statistical Commission. This paper describes the concepts for the measurement of IFFs, as developed jointly by UNODC and UNCTAD and a dedicated international Task Force.

Keywords:
Illicit financial flows; IFFs; crime; illegal markets; tax evasion; official statistics

1. Introduction:
As the world searches for the funds needed to recover from the COVID-19 pandemic and achieve the 2030 Agenda (United Nations, 2015), potentially billions of dollars of illicit financial flows (IFFs) slip through the cracks every year. IFFs stemming from organized crime, trade in illegal goods, corruption and illegal and illicit tax and commercial practices move across borders draining resources from development.

These flows weaken state institutions by encouraging corruption and undermine the rule of law and the functioning of the criminal justice systems. They also divert resources that are needed for essential services. UNCTAD's Economic Development in Africa Report (2020) found that some countries with high IFFs spend on average 25 per cent less on health and 58 per cent less on education compared with countries with low IFFs. By eroding the tax base and discouraging public and private investment, they hamper structural transformation, economic growth, and sustainable development.

UNCTAD and UNODC, assigned by the General Assembly as custodians of indicator 16.4.1, lead methodological work to develop statistical definitions and methods to measure the total value of inward and outward illicit financial flows. As a result of this work, UNCTAD and UNODC (2020) published a Conceptual Framework for the Statistical Measurement of Illicit Financial Flows, reflecting concepts and standards approved by the IAEG-SDGs and the

United Nations Statistical Commission. This document reflects main messages of the Conceptual Framework.

In February 2021, these concepts were subsequently adopted in the Report of the High-Level Panel on International Financial Accountability, Transparency and Integrity (FACTI) for Achieving the 2030 Agenda (United Nations, 2021), noting that UNCTAD and UNODC together "developed the first statistical definition of the term to contribute to the development of SDG indicators".

The progress is the result of a consultative process and the establishment of the UNCTAD/UNODC Statistical Task Force on IFFs[1] in January 2019. The resulting concepts and methodological proposal were endorsed by the IAEG-SDGs in October 2019 when indicator 16.4.1 was reclassified from Tier III to Tier II, meaning that the indicator is conceptually clear and based on internationally established standards, while data are not yet available from countries.

Now pioneering countries across continents are testing the Conceptual Framework and Methodological Guidelines to measure IFFs. Pilots are being carried out across Africa, Asia and the Pacific, Europe, and Latin America in coordination with the United Nations Regional Commissions. This paper will describe the concepts for the measurement of IFFs, developed jointly by UNODC and UNCTAD.

2. Statistical definition of IFFs

For the purpose of the SDG indicator, IFFs are defined as financial flows that are illicit in origin, transfer or use that reflect an exchange of value and that cross country borders, with the following features:

(a) **Illicit in origin, transfer or use**. A flow of value is considered illicit if it is illicitly generated (e.g., originates from criminal activities or tax evasion), illicitly transferred (e.g., violating currency controls) or illicitly used (e.g., for financing terrorism). The flow can be legally generated, transferred or used, but it must be illicit in at least one of these aspects. Some flows that are not strictly illegal may fall within the definition of IFFs, e.g., cross-border tax avoidance which erodes the tax base of a country where that income was generated.

(b) **Exchange of value rather than money or purely financial transfers**. Exchanges of value include not only currency exchanges, but also exchanges of goods and services, and financial and non-financial assets.

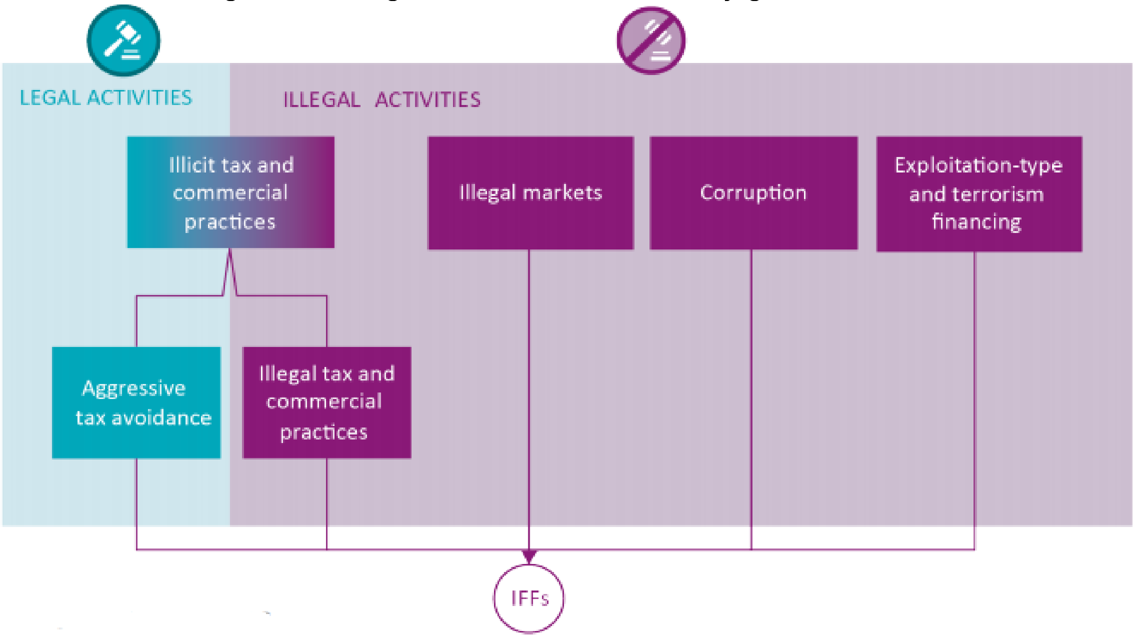
(c) **IFFs measure a flow of value over a given time**, as opposed to a stock measure, which would be the accumulation of value.

(d) **Flows that cross a border**. This includes assets where the ownership changes from a resident of a country to a non-resident, even if the assets remain in the same jurisdiction.

IFFs can be classified from many angles: sources, channels, impacts, actors involved, and motives, etc. Figure 1 presents the main categories of activities that may generate IFFs.

[1] The Task Force is composed of statistical experts from Brazil, Finland, Ireland, Italy, Peru, South Africa and the United Kingdom, representing national statistical offices, central banks, customs or tax authorities. The Task Force also includes experts from international organisations with recognised expertise in this field. ECLAC, ESCAP, Eurostat, IMF, OECD, UNECA, UNSD, UNCTAD and UNODC are represented.

Figure 1. Categories of activities that may generate IFFs.



Source: UNODC and UNCTAD.

According to this typology, four main categories of IFFs are distinguished:

(a) **Illicit tax and commercial IFFs**. This category includes illicit practices by legal entities as well as arrangements and individuals with the objective of concealing revenues, reducing tax burden, evading controls and regulations and other purposes. This category can be divided into two components:

(i) **IFFs from illegal commercial and tax practices**. These include illegal practices such as tariff, duty and revenue offences, tax evasion, corporate offences, market manipulation and other selected practices. Related activities included in the International Classification of Crime for Statistical Purposes (ICCS) comprise tax evasion, tariff, duty and revenue offences, competition offences, import/export offences, acts against trade regulations, restrictions or embargoes and investment or stack/shares offences.

(ii) **IFFs from aggressive tax avoidance**. Illicit flows can also be generated from legal economic activities through what is sometimes called harmful or aggressive tax avoidance (see UNCTAD and UNODC, 2020). Aggressive tax avoidance can take place through a variety of forms, such as manipulation of transfer pricing, strategic location of debt and intellectual property, tax treaty shopping, and the use of hybrid instruments and entities. For the purposes of the measurement of the indicator, these flows need to be carefully considered, as they generally arise from licit business transactions and only the illicit part of the cross-border flows belongs to the scope of IFFs.

(b) **IFFs from illegal markets**. These include trade in illicit goods and services, when the money flows generated cross country borders. Such processes often involve a degree of criminal organisation aimed at creating profit. They include any type of illegal trafficking of goods, such as drugs and firearms, or services, such as smuggling of migrants. IFFs are generated by the flows related to international trade of illicit goods and services, as well as by cross-border flows from managing the illicit income from such activities.

(c) **IFFs from corruption**. The United Nations Convention against Corruption (UNCAC) (UNODC, 2004) defines acts considered as corruption which are consistently defined in the ICCS. These include bribery, embezzlement, abuse of functions, trading in influence, illicit enrichment and other acts. When the economic returns from these acts directly or indirectly generate cross-border flows, they are considered IFFs.

(d) **IFFs from exploitation-type activities and financing of crime and terrorism**. Exploitation-type activities are illegal activities that entail a forced and/or involuntary transfer of economic resources between two actors. Examples include slavery and exploitation, extortion, trafficking in persons, and kidnapping. In addition, terrorism financing and financing of crime are illicit, voluntary transfers of funds between two actors with the purpose of funding criminal or terrorist actions. When the related financial flows cross country borders, they constitute IFFs.

3. Towards a statistical classification

IFFs need to be classified using a discrete, exhaustive and mutually exclusive statistical classification aligned with existing statistical frameworks and principles (OECD, 2021). The ICCS (UNODC, 2015) is a good point of departure for defining some of the activities that could generate IFFs, such as exploitation-type activities and terrorism, illicit trafficking and corruption, as well as many activities related to tax and commercial malpractices. However, IFFs that are not part of illegal activities may not be covered and an extended classification is being developed. Table 1 provides examples of such activities and how to link the main categories of IFFs to activities that generate them.

Table 1. Examples of activities generating illicit financial flows, by ICCS category

CATEGORIES OF IFFS	EXAMPLES OF ACTIVITIES BY ICCS CATEGORY
Tax and commercial practices	08041 Tariff, taxation, duty and revenue offences 08042 Corporate offences including competition and import/export offences; acts against trade regulations 08045 Market manipulation or insider trading, price fixing
Exploitation-type activities and terrorism financing (parts of sections 02, 04, 09)	020221 Kidnapping 0203 Slavery and exploitation 0204 Trafficking in persons 0302 Sexual exploitation 02051 Extortion 0401 Robbery 0501 Burglary 0502 Theft 09062 Financing of terrorism
Illegal markets	ICCS includes a long list of activities, including for example drug trafficking (060132), firearm trafficking (090121), illegal mining (10043), smuggling of migrants (08051), smuggling of goods (08044), wildlife trafficking (100312)
Corruption (section 0703)	07031 Bribery 07032 Embezzlement 07033 Abuse of functions 07034 Trading in influence 07035 Illicit enrichment 07039 Other acts of corruption

The ICCS describes the actions and behaviours relating to each category and provides examples of the types of activities concerned. The above-listed activities are also sources of IFFs. It would be useful to link the categories of IFFs and their source activities to their transmission channels. This requires further consideration since similar financial flows may apply to a variety of channels. Data availability and the selection of statistical methods are likely to depend on the type of activity generating IFFs and the channels used.

Moreover, while ICCS considers illicit activities, such as acts against public revenue provisions and acts involving behaviour that is regulated or prohibited on moral or ethical grounds (0804), it focuses on actions and behaviours that are attributable to different types of crime. A classification for measuring IFFs is being developed to cover all IFFs related to tax and commercial activities.

4. Discussion and Conclusion

This approach considers the multi-dimensional nature of IFFs, comprising several different kinds of activities, including flows originating from illicit activities, illicit transactions to transfer funds that have a licit origin, and flows stemming from licit activity being used in an illicit way. The Conceptual Framework identifies main types of IFFs to be measured and lays out a frame based on existing statistical definitions, classifications and methodologies, in line with the System of National Accounts (SNA) and Balance of Payments.

The Conceptual Framework presented in this document has proved useful for assessing IFFs from trade in illegal commodities, as demonstrated by pilot tests in Latin American countries, namely Columbia, Peru, Ecuador, and Mexico. In 2021, several pilots are being carried out in Africa and Asia and the Pacific, but also in some European and additional Latin American countries.

In addition to testing methods to measure IFFs, the pilots will inform the refinement of the Conceptual Framework, especially for the further development of a statistical classification of IFFs based on ICCS. Many illicit activities are intertwined, such as bribery related to drug trafficking or trade mispricing. To avoid duplication, measurement should be based on an exclusive statistical classification that, as far as possible, separates types of IFFs, for instance, IFFs from corruption and IFFs from other illicit activities.

While SDG indicator 16.4.1 aims at an aggregate measure of IFFs, a nuanced measurement of different types of IFFs will be key to support policy action. The ability to achieve the SDGs remains fragile when undermined by IFFs. Indeed, the 2030 Agenda for Sustainable Development underscores the need for an increased mobilization of financial resources dedicated to sustainable development, including through the improved capacity for revenue collection, and for more resources dedicated to investment.

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